<u>TESTIMONY OF WILLIAM C. POWERS, JR.</u>
Chairman of the Special Investigative Committee
Of the Board of Directors of Enron Corporation

Before the
Committee on Commerce, Science and Transportation
United States Senate

February 12, 2002

Mr. Chairman and distinguished Members of the Committee. My name is William Powers. I am the Dean of the University of Texas Law School. For the past three months, I have served as Chairman of the Special Investigative Committee of the Board of Directors of Enron Corporation. I appreciate the opportunity to come and testify before you today.

As you know, during October of last year, questions were being raised about Enron's transactions with partnerships that were controlled by its Chief Financial Officer, Andrew Fastow. In the middle of October, Enron announced that it was taking an after-tax charge of more than $500 million against its earnings, because of transactions with one of those partnerships. Enron also announced a reduction in shareholder equity of more than a billion dollars. At the end of October, the Enron Board established a Special Committee to investigate these matters, and then asked me if I would join the Board for the purpose of chairing that Committee, and conducting that investigation. With the help of counsel from Wilmer, Cutler & Pickering and professional accounting advisors from Deloitte & Touche, we have spent the last three months conducting that investigation.

Our Committee's Report was filed on February 2. It covers a lot of ground and will, I hope, be a helpful starting point for the necessary further investigations by Congressional Committees, by the Securities and Exchange Commission, and by the Department of Justice. A copy of the Executive Summary is attached to my Statement here.

Many questions currently part of public discussion—such as questions relating to the employees' retirement savings and sales of Enron securities by insiders—are beyond the scope of the charge we were given. These are matters of vital importance. The employees' loss of their retirement plans is a tragic story. But we did not address these matters in our Report.

We were charged with investigating transactions between Enron and partnerships controlled by its Chief Financial Officer, or people who worked in his department. That is what our Report discusses. Mr. Chairman, as I have said before: What we found was appalling.

First, we found that Fastow—and other Enron employees involved in these partnerships—enriched themselves, in the aggregate, by tens of millions of dollars they should never have received. Fastow got at least $30 million, Michael Kopper at least $10 million, two others $1 million each, and still two more amounts we believe were at least in the hundreds of thousands of dollars.

Second, we found that some transactions were improperly structured from an accounting point of view. It is important to note that, if they had been structured correctly, Enron could have kept assets and liabilities (especially debt) off of its balance sheet. But Enron did *not* follow the accounting rules.

But we found something even more troubling than those individual instances of misconduct, and failures to follow accounting rules. We found a systematic and pervasive attempt by Enron's Management to misrepresent the Company's financial condition. Enron Management used these partnerships to enter into transactions that it could not, or would not, do with unrelated commercial entities. Many of the most significant transactions apparently were not designed to achieve bona fide economic objectives. They were designed to affect how Enron reported its earnings.

As our Report demonstrates, these transactions were extremely complex. I won't try to describe them in detail here. But I do think it would be useful to give just one example. It involves efforts by Enron to "hedge" against losses on investments it had made.

Enron was not just a pipeline and energy trading company. It also had large investments in other businesses, some of which had appreciated substantially in value. These were volatile investments, and Enron was concerned because it had recognized the gains when these investments appreciated, and it didn't want to recognize the losses if the investments declined in value. So Enron purported to enter into certain "hedging" transactions in order to avoid recognizing losses from its investments. The problem was that the hedges weren't real. The idea of a hedge is normally to contract with a credit-worthy outside party that is prepared—for a price—to take on the economic risk of an investment. If the value of the investment goes down, that outside party will bear the loss. That is not what happened here. Essentially, Enron was hedging with itself.

The outside parties with which Enron "hedged" were the so-called "Raptors." The purported outside investor in them was a Fastow partnership. In reality, these were entities in which only Enron had a real economic stake, and whose main assets were Enron's own stock. The notes of Enron's corporate secretary, from a meeting of the Finance Committee regarding the Raptors, capture the reality: "Does not transfer economic risk but transfers P+L volatility." These were not real economic hedges; they just affected Enron's earnings statement by allowing Enron to avoid reporting losses on its investments.

As it turned out, the value of Enron's investments fell at the same time that the value of Enron stock fell, and the Raptors became unable to meet their obligations on the "hedges." But even if the hedges had not failed in the sense I just described, the Raptors would have paid Enron with the stock that Enron had provided in the first place; Enron would simply have paid itself back.

This raises an important point that is easy to miss in the thicket of these very complex transactions. There has been much discussion about who understood what about Fastow and his partnerships. But there is no question that virtually everyone, from the Board of Directors on down, understood that the company was seeking to offset its investment losses with its own stock. That is not the way it is supposed to work. Real earnings are supposed to be compared to real losses.

As a result of these transactions, Enron improperly inflated its reported earnings for a 15-month period—from the third quarter of 2000 through the third quarter of 2001—by more than $1 billion. This means that more than 70 percent of Enron's reported earnings for this period were not real.

How could this have happened? The tragic consequences of the related-party transactions and accounting errors were the result of failures at many levels and by many people: a flawed idea, self-enrichment by employees, inadequately-designed controls, poor implementation, inattentive oversight, simple (and not-so-simple) accounting mistakes, and overreaching in a culture that appears to have encouraged pushing the limits.

Whenever this many things go wrong, it is not just the act of one or two people. There was misconduct by Fastow and other senior employees of Enron. There were failures in the performance of Enron's outside advisors. And there was a fundamental default of leadership and management.

Leadership and management begin at the top, with the CEO, Ken Lay. In this company, leadership and management depended as well on the Chief Operating Officer, Jeff Skilling. And it depended on the Board of Directors.

In the end, this is a tragedy that could and should have been avoided. I hope that our Report, and the work of this Committee, will help reduce the danger that it will happen to some other company.